

Internal Revenue Service  
**memorandum**

CC:FS:TL-N-316-92

CORP:LEGardner

date: OCT 11 1991

to: District Counsel, Oklahoma City CC:OKL  
Attn: Gary L. Bloom

from: Assistant Chief Counsel (Field Service) CC:FS

subject: [REDACTED]

We communicated to you verbally on September 26, 1991, our recommendations on the issue in this case. This is a written response to your request for Tax Litigation Advice, dated August 30, 1991.

ISSUE

Whether the \$ [REDACTED] distribution from [REDACTED], a wholly owned subsidiary of [REDACTED], to [REDACTED] constitutes a dividend for tax purposes or whether the step transaction doctrine should apply so that the distribution is treated as part of the purchase price for the stock of [REDACTED] which was received from [REDACTED], an unrelated third party.

CONCLUSION

We conclude that the step transaction doctrine is not applicable to the facts in this case and, therefore, the \$ [REDACTED] distribution constitutes a dividend for tax purposes.

FACTS

We incorporate the facts as noted in the supporting statement sent to this office by district counsel. After further discussions with District Counsel, we note that [REDACTED]'s adjusted basis in the stock of [REDACTED] as of [REDACTED], was \$ [REDACTED]. This basis was adjusted for earnings and profits for [REDACTED] through [REDACTED]. The Agent verified the amounts and there is no dispute regarding the correct basis as of [REDACTED]. Further, for the fiscal year ended [REDACTED], [REDACTED] owned directly at least [REDACTED] shares of class B common stock of [REDACTED] and possessed at least [REDACTED] percent of the voting power of all classes of stock of [REDACTED]. Any change in voting power did not occur until [REDACTED].

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### DISCUSSION

In Waterman Steamship Corporation v. Commissioner, 430 F.2d 1185 (5th Cir. 1970), revg. 50 T.C. 650 (1968), the taxpayer, Waterman Steamship Corporation, received an offer from McLean Securities Corporation to purchase the stock of two of its wholly owned subsidiary corporations, Pan-Atlantic Steamship Corporation and Gulf Florida Terminal Company, Inc., for \$3,500,000 cash. The board of directors of Waterman Steamship Corporation rejected that offer but countered with an offer to sell the two subsidiaries for \$700,000 after the subsidiaries declared and arranged for payments of dividends to Waterman Steamship Corporation amounting in the aggregate to \$2,800,000. This offer was accepted. The agreement called for the purchaser to loan or otherwise advance funds to Pan-Atlantic Steamship Corporation promptly in order to pay off the promissory note by which the dividend had been paid. The entire transaction was carried on the same day. On January 20, 1955, Pan-Atlantic Steamship Corporation declared dividends on its preferred and common stock to its stockholders in the form of a promissory note for \$2,799,820. On the same date, the board of directors of McLean Securities Corporation authorized the purchase of the stock of Pan-Atlantic Steamship Corporation and Gulf Florida Terminal Company, Inc., for \$700,180.

The issue before the court was whether the distribution of a promissory note by Pan-Atlantic Steamship Corporation to Waterman Steamship Corporation was a dividend or part of the purchase price for the sale by Waterman Steamship Corporation of the stock of Pan-Atlantic Steamship Corporation and Gulf Florida Terminal Company to McLean Securities Corporation. The Fifth Circuit applied the step transaction doctrine and held that in substance the dividend was part of the purchase price paid by an unrelated third party. The court noted that, in determining that the step transaction doctrine applied, an important factor was that the declaration of the dividend and the sale of the stock were concluded on the same day, which was evidence that the declaration of the dividend and the sale were prearranged.

In Commissioner v. Litton Industries, Inc., 89 T.C. 1086 (1987), acquiesced in result only, 1988-2 C.B. 1, Litton Industries, Inc., owned 100 percent of the stock of Stouffer Corporation. In early 1972, the board of directors of Litton Industries, Inc., considered selling the stock of Stouffer Corporation. On August 23, 1972, Stouffer Corporation declared a dividend of \$30 million which it paid to Litton Industries, Inc., in the form of a promissory note. At that time, the chairman of Litton's Industries, Inc., and the board of directors believed that Litton Industries, Inc., would have no difficulty in receiving an adequate offer for the stock of Stouffer Corporation. On September 7, 1972, Litton Industries, Inc.,

announced publicly its interest in disposing of the stock of Stouffer Corporation. On March 5, 1983, Nestle Alimentana purchased all the outstanding stock of Stouffer Corporation from Litton Industries, Inc., and paid \$30 million in cash for the promissory note.

The issue for decision was whether the \$30 million dividend declared by Stouffer Corporation was truly a dividend for tax purposes or whether it should be considered part of the proceeds received by Litton Industries, Inc., from the sale of all of the stock in Stouffer Corporation on March 1, 1973. The court noted that the dividend was declared six months prior to the sale of Stouffer, and Stouffer had earnings and profits exceeding \$30 million at the time the dividend was declared. These factors indicated that the sale was not prearranged. Therefore, the court could not conclude that the distribution was merely a device designed to give the appearance of a dividend to a part of the sales proceeds. The court noted that the form and the substance of the transaction coincided, it was not a transaction entered into solely for tax purposes, and it should be recognized as structured by the taxpayer. The court held that the \$30 million distribution constituted a dividend for tax purposes.

The court in Litton Industries, Inc., compared the facts in that case with the facts in Waterman Steamship Corporation. The factors discussed are as follows. First, the court noted that the principal difference in the facts in that case and in Waterman Steamship Corporation was that the dividend and sale in Litton Industries, Inc. were substantially separated in time in contrast to the dividend and sale in Waterman Steamship Corporation. In Litton Industries, Inc., the dividend was declared by Stouffer Corporation on August 23, 1972. Two weeks later, Litton Industries, Inc., announced that Stouffer Corporation was for sale. More than six months later, Stouffer Corporation was sold. In Waterman Steamship Corporation, the dividend was declared on the same day as the sale. Second, in Waterman Steamship Corporation, it was clear that a dividend would not have been declared if all of the remaining steps in the transaction had not been lined up, whereas, in Litton Industries, Inc., Stouffer Corporation could have raised sufficient revenue for the dividend from other avenues. The taxpayer in Litton Industries, Inc. committed itself to the dividend and accepted the consequences regardless of the outcome of the proposed sale of Stouffer Corporation. The court in Litton Industries, Inc. was not persuaded that the subsequent sale of Stouffer Corporation would change the fact that the \$30 million distribution would constitute a dividend merely because it was more advantageous to Litton Industries, Inc., from a tax perspective. Third, the court in Litton Industries, Inc., pointed out that even though Litton Industries, Inc., intended to sell Stouffer Corporation at the time the dividend was declared,

there was no formal action taken; no announcement of a sale had been made; there was no definite purchaser waiting in the wings with the terms and conditions of sale already agreed upon, and Litton Industries, Inc., had not decided upon the form of the sale of Stouffer Corporation. The above factors led the court to conclude that there was not any prearranged sale agreement, formal or informal, at the time the dividend was declared. In contrast, in Waterman Steamship Corporation, it was obvious that there was a formal agreement of sale on the same day the dividend was declared which strongly suggested that the dividend was tied into the sales agreement. Fourth, the court in Litton Industries, Inc., added that another factor to be considered in determining whether the overall transaction was a sham is whether a dividend has a business purpose. In Litton Industries, Inc., there appeared to be a business purpose. However, the court pointed out that this factor is not a necessary requirement deciding the issue.

The facts in the instant case are somewhat similar to the facts in Litton Industries, Inc.. In this case, in [REDACTED] and [REDACTED], [REDACTED] expressed an interest in acquiring [REDACTED]. However, there is no documentary or other evidence that there was a meetings of the minds between the parties with respect to a sale. On [REDACTED], [REDACTED] declared a dividend of \$ [REDACTED]. On [REDACTED], [REDACTED] entered into a letter of intent with the [REDACTED] group. On [REDACTED], a sales agreement between [REDACTED] and [REDACTED] was signed. It is expected that [REDACTED] will testify at trial that serious negotiations with [REDACTED], which culminated in a sales agreement, were not entered into until after the declaration of the dividend.

When we look at the factors considered in Litton Industries, Inc., we have to conclude that it would not be appropriate to apply the step transaction doctrine in this case. There is no evidence to establish that the declaration of the dividend and the ultimate sale was prearranged. First, the span of time between the declaration of the dividend and the sale is significant. Second, the dividend was paid in cash which came from [REDACTED], not from the purchaser of the stock of [REDACTED]. The taxpayer committed itself to the dividend, and accepted the consequences regardless of the outcome of the proposed sale. Third, even though we can conclude that [REDACTED] intended to sell [REDACTED] as early as [REDACTED], there is no evidence that any formal action had been taken at that time; and no announcement was made of a future sale. We cannot conclude that there was a definite purchaser "waiting in the wings with the terms and conditions of the sale already agreed on," because there is no evidence that the earlier negotiations resulted in any definite agreement between the parties. There is no evidence that the form of the sale was decided upon prior to the declaration of the dividend. The facts do not indicate whether [REDACTED] had a business purpose

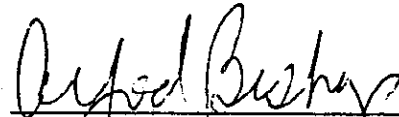
for the dividend. However, this factor is not a requirement, but merely one of the factors to take into account in determining whether the overall transaction is a sham. In conclusion, there is insufficient evidence in this case to prove that there was any prearranged sale agreement, formal or informal, prior to or at the time the dividend was declared. In this case, as in Litton Industries, Inc., the form and the substance of the transaction appear to coincide. There is insufficient evidence to conclude that this transaction was entered into solely for tax purposes. Therefore, we conclude that \$[REDACTED] distribution constitutes a dividend for tax purposes.

A possible issue to address is at what level the sale actually occurred, [REDACTED] or [REDACTED]. However, [REDACTED] never received more than \$[REDACTED] when they sold their stock in [REDACTED]. We cannot attribute the \$[REDACTED] to [REDACTED]. Therefore, we do not need to consider the issue of where the sale actually occurred because the tax consequences of the transaction would not be changed.

If you have any questions regarding this matter, please call Lorraine E. Gardner, at (FTS) 566-3335.

DANIEL J. WILES

By:



ALFRED C. BISHOP, JR.  
Chief, Corporate Branch  
Field Service